2005 ANNUAL REPORT

Loon

LOON ENERGY INC.

Contents

Stockholder Information

As of December 31, 2005, the number of common shares outstanding was 68,733,344. As of the date if this annual report, the number of common shares outstanding is 70,911,344. The Annual & Special General Meeting of Loon Energy Inc. will be held at 3:00 pm Calgary time on Wednesday, June 7, 2006 at the Calgary Petroleum Club (McMurray Room), 319 – 5th Avenue SW, Calgary, Alberta, Canada.

Loon Energy Inc. is a public company with international oil and gas exploration and development projects in Latin America, south-central Europe and southeast Asia. The common shares of Loon trade on the TSX Venture Exchange under the symbol "LEY".

Offices Projects

MESSAGE TO SHAREHOLDERS

Loon's level of activity significantly increased in 2005. During the year the company:

- entered into a major land earning agreement in Colombia;
- raised $20 million Cdn by private placement in March;
- drilled 2 wells in Colombia resulting in a gas well and a dry hole;
- shot a 3D seismic survey in Colombia;
- fracture stimulated the D14 well in Slovenia;
- established an office in Dubai;
- prepared a bid for a large (880 sq. mile) block in Brunei; and
- submitted bids for two large (8,000 sq. km) exploration blocks in Syria.

The Company is opportunity driven and is continuously evaluating opportunities to access projects which would be meaningful to the shareholders of Loon if acquired.

Since the end of the 2005 fiscal year we have;

- been awarded the right to negotiate a Production Sharing Contract covering Block L in Brunei;
- drilled a third well in Colombia in which no commercial hydrocarbons have been found;
- put together a transaction in an Asian country which, upon receipt of government approvals in that country, will result in Loon acquiring shares of Proprietary Industries Inc. (TSX:PPI) with a current market value of approximately $12 million Cdn; and
- commenced a re-stimulation and evaluation of the D14 well in Slovenia.

Colombia

Activities continued to escalate during the 2005 fiscal year. Early in the year, Loon entered into an agreement with Kappa Energy Colombia Limited S.A. to acquire a 49% interest in the Abanico Association Contract (the "Contract") in the Magdelena Basin area of central Colombia. The Contract covers an area of more than 200,000 acres (> 300 square miles) in an area prospective for accumulations of both oil and natural gas. The first two wells drilled as a part of our earning commitment were drilled in the third and fourth quarter resulting in a gas well and a dry hole. A third well, drilled during the first quarter of 2006 did not yield commercial hydrocarbons and is suspended.

The Ventilador-2 well, the first well drilled by Loon in Colombia, was spud in late August and drilled, logged, cased to a total depth of 518 metres and tested by the end of the third quarter. The well encountered a total of 80 feet (25.4 metres) of net pay out of a 90 foot gross sand interval. The gas zone was perforated in two separate intervals and flow tested with an initial natural gas flow rate of 850 Mcfd increasing during a 51 hour test to over 2.5 MMcfd at a stable pressure of 575 psi. The well is expected to be tied-in for commercial gas production by mid-2006.

The Aleli-1 well, the second hole to be drilled by Loon in Colombia as part of its Abanico earning commitment, was spud in late September and reached a total depth of 6,633 feet (2,021 metres) before being logged and abandoned. The primary objective, sands in the Guadalupe Formation contained within a large anticlinal feature defined by 2D seismic, was not hydrocarbon-bearing at this location.

A 3D seismic program undertaken by Loon and Kappa was completed during the third quarter and evaluated by the end of the fiscal year. The interpretation indicated that the Ventilador-2 well, which was drilled on a 2D seismic anomaly, was not drilled at the most optimum location and defined a number of other prospects and leads for future exploration. One of these was drilled early in 2006 at Duna-1.

The Duna-1 well was spud in mid-February, drilled to a total depth of 4,672 feet on a location defined by the 3D seismic program. The primary objectives of the well, two potential reservoirs below 3,800 feet, did not contain hydrocarbons at this location and the well was suspended pending possible further evaluation of the gas potential of shallower reservoirs.

The Abanico Block is surrounded by multiple oil fields with reserves in the tens of millions of barrels and the Company is exploring for pools of similar size. Although success in Colombia has been less than initially expected, the Company remains committed to the Abanico Block and to exploration in Colombia.

Generally speaking, there are few places in the world where reservoirs of this size can be drilled in relatively close proximity to one another and where costs of drilling and production are not prohibitive. It is a very favourable place to explore for and develop hydrocarbons and the Company is working to expand its acreage position in Colombia.

Slovenia

Testing of the D14 well (Loon 10.5%), drilled to a depth of 2,805 metres at no cost to Loon to evaluate deep gas potential was tested during the early part of the first quarter of the 2005 fiscal year and did not indicate commercial production. Over the course of the year pressures were monitored and late in the year a decision was made to re-enter the well, evaluate the zones already drilled and, if deemed appropriate by the partners, deepen the well to evaluate the potential of zones expected to occur at greater depth in the Petisovci structure. This work got underway in April, 2006 and is being conducted at no cost to Loon.

Brunei

In the second quarter of 2005, Loon commenced discussions with a private company with extensive experience in Brunei. This led to the formation of a group with Loon as the operator which submitted a successful bid to undertake work on a large (approximately 550,000 acre) block of prospective acreage covering approximately 35% of the onshore area of Brunei. Block L was awarded to Loon et al in early February, 2006. Negotiations on the Production Sharing Contract commenced in early March and are on-going.

Asia

Loon and a private Dubai-based oil and gas exploration company jointly (50/50) evaluated and completed the negotiations of a series of contracts to acquire varying interests covering several large acreage blocks in an Asian country which include an undeveloped gas field. The cash commitment required to finalize the deal was US$25 million (US$12.5 million net). In April, 2006, Loon and the its partner reached an agreement with Proprietary Industries Inc. (TSX: PPI) ("Proprietary") under which they transferred all rights to these contracts to Proprietary in exchange for common shares of Proprietary.

Once the transaction receives the approval of government regulators Loon will end up owning 7,479,419 common shares of Proprietary making it the single largest shareholder of that company. The value of these shares to Loon, at the time of writing this message to shareholders, is approximately $12 million Cdn.

Mediterranean Area

Loon has been active pursuing potential opportunities in a number of countries in the Mediterranean area. News releases will be made in the event that any of these opportunities lead to a formal agreement or the grant of a negotiating right.

Latin America

In addition to existing projects in Colombia, Loon is evaluating the potential for expanding its presence in Colombia and of a possible involvement in exploration projects in Peru. News releases will be made in the event that any of these opportunities lead to a formal agreement or the grant of a negotiating right.

Personnel

The appointment of Tim Elliott as President and Chief Executive Officer and Jock Graham as Vice President was announced in February 2006. Tim and Jock are both located in Loon's office in Dubai, United Arab Emirates.

Governance

The appointment of Michael A. McVea of Victoria, British Columbia to the Loon board of directors was announced in early February. Mike was previously on the board of TKE Energy Trust prior to November 2004.

Financing

A "bought deal" private placement was closed in March, 2005 raising total gross proceeds of approximately $20 million Cdn. These funds have been employed to meet our earning commitment in Colombia and to fund the efforts of the Company on new projects in Brunei and elsewhere.

Summary

The level of activity at Loon has grown substantially in each of the past several years. In 2005, we started our involvement in Colombia and completed our first significant financing. In the first four months of 2006 we have been awarded a contract area in Brunei and closed a deal under which we sold our rights to acquire interests in a number of projects in an Asian country for shares of Proprietary.

We will continue to pursue strategic opportunities to increase the value of Loon on a per share basis and look forward to an active year of additional growth in 2006.

On behalf of the board of directors

"signed"

Norman W. Holton
Chairman

"signed"

Timothy M. Elliott
President & Chief Executive Officer

HIGHLIGHTS 2005

February

Fracture Stimulation of D-14 Well

Production testing of tight gas sands in the Pg zone began. The sands had been fracture stimulated during the month of January and the early part of February.

Loon Negotiates Deal in Colombia

Loon announced that it had entered into an agreement to explore for and produce hydrocarbons in Colombia. Loon will expend a minimum of US$6 million to participate in a 3D seismic program and drill a minimum of three wells to earn a 49% interest in more than 312 square miles of lands.

March

Update on D-14 Well

The well continues to flow minor amounts of gas. Well is showing signs of formation damage and it is believed that damage may have occurred during the fracture stimulation process.

Financing Closed

A "bought deal" private placement was closed raising total gross proceeds of approximately $20 million. The offering consisted of 21,052,636 common shares at $0.95. The net proceeds of the offering will be used for the drilling of exploration and development wells and the shooting of 3D seismic in Colombia, working capital and/or expanded capital expenditures.

April

Colombia – Drilling & Seismic Plans

Loon announced that the 3D seismic will be shot during the second quarter of the 2005 fiscal year and that the first of the earning wells is expected to spud in late June.

July

Program Update – Colombia

Loon provided an update on activities in Colombia indicating that drilling of the first well on the Abanico Association Contract was expected in August and that a Loon et al 3D seismic shoot was underway

August

Start of Drilling in Colombia

Loon announced that the Ventilador-2 well, the first well of its Colombian drilling program, was spud on August 25th, that a second drilling rig was on the move to Aleli-1, the second well in the program and that seismic acquisition was nearing completion.

September

Loon Drills Gas Well in Colombia

The Ventilador-2 well has been cased as a gas well with approximately 80 feet of net pay indicated on logs. The gas sand was encountered at 518 metres (1,700 feet) and was flow tested at 2.5 MMcfd at a stable pressure of 575 psi.

Loon Spuds Aleli Deep Test in Colombia

The Aleli-1 well was spud on September 21st. The well is targeting a large structure with a planned total depth of 7,800 feet (2,377 metres).

October

Update on Aleli Deep Test in Colombia

The Aleli-1 well has reached a depth of 3,932 feet (1,198 metres) as of October 3rd and intermediate casing has been run to that depth.

November

Aleli-1 Drilling Update

The Aleli-1 well reached a depth of 6,633 feet as of November 3rd. A mechanical failure suspended drilling and the drill string became stuck. A repair was completed and the drill string was fully recovered. The well was logged to depth drilled.

December

Aleli-1 Well Abandoned

The Aleli-1 well was plugged and abandoned. Velocity data from the logs indicated that a substantial portion of the target structure had already been penetrated at a total drilled depth of 6,633 feet without finding commerical hydrocarbons.

February

Loon Awarded Contract in Brunei

A consortium led by Loon and including QAF Brunei Sdn Bhd was awarded Block L, which covers 2,253 square kilometres (880 square miles) in Brunei Darussalam. Block L is located mostly onshore in the northeastern part of Brunei. The award is subject to the finalization of a Production Sharing Contract between Loon et al and the Brunei National Petroleum Company Sendirian Berhad.

Loon Spud Duna-1 Well in Colombia

The third well to be drilled by Loon as a part of its spending commitment on the Abanico Association Contract was spud at Duna-1. The location was defined by 3D seismic and has a targeted total depth of 4,100 feet.

Loon Appoints Officers & New Director

Timothy Elliott was appointed President and Chief Executive Officer. Tim has been a director of Loon since 2001. He received his law degree from the University of Ottawa in 1985 and has been active in the international oil and gas industry since 1987. Jock Graham was appointed Vice President. Jock has been a consultant to Loon since the fall of 2004. He received has geology degree in 1982 from St. Francis Xavier University and has been active in the international oil and gas industry since 1988. Tim and Jock are based in Loon's office in Dubai, United Arab Emirates.

Loon Appoints New Director

Michael McVea was appointed as a seventh director of Loon. Mr. McVea practiced law in the Province of British Columbia for 30 years prior to his retirement in 2004. He was a director of TKE Energy Trust prior to the formation of True Energy Trust in November, 2005.

March

Update on Colombia

Colombia – Drilling operations at Duna-1 reached a total depth of 4,672 feet. Neither of the two primary objectives of the well are capable of production at this location. Shallower zones which appear prospective for natural gas production will be evaluated at a later date.

Update on Brunei

The first round of negotiations on the production sharing contract took place in early March.

April

Proprietary, Loon and Nemmoco Enter Into Agreement on Asian Property

On April 18th, Proprietary Industries Inc. and Loon announced that Proprietary had acquired the interests of Loon and Nemmoco Petroleum Limited, a private company, in a private Bermuda company which is a party to a series of farm-in agreements which, subject to the approval of various government agencies involve the acquisition of certain oil and gas interests in Asia. As consideration, Loon received 7,479,419 common shares of Proprietary. Proprietary trades on the TSX under symbol "PPI".

COLOMBIA

Deal Summary

On February 18, 2005, Loon announced that it had entered into an agreement with Kappa Energy Colombia Limited S.A. to explore for and produce hydrocarbons in the Republic of Colombia. Under the terms of the agreement, Loon agreed to expend a minimum of US$6 million to earn a 49% working interest in Kappa's rights in the Abanico Association Contract area. The Abanico block, which covers an area of more than 300 square miles (> 200,000 acres), is located in the Magdalena Valley of central Colombia – an area known for its oil and gas accumulations. Kappa's existing producing property within the contract area was excluded from Loon's earning arrangement.

As part of its obligation, Loon committed to participate in a 28 km^2 3D seismic program and in a minimum of three wells, two of which were drilled during fiscal 2005. The third well was drilled in the first quarter of 2006.

Doing Business in Colombia

Colombia has a long history of oil and gas exploration and production. Current production is almost 600,000 boepd (mostly oil). More than half of the oil produced is exported to the United States. There are over sixty independent petroleum companies operating in Colombia – a testament to the stability of the country, a favourable business environment and the general prospectivity of the area.

Prolific Oil Producing Area

Colombia shares high quality oil and gas source rocks with neighboring Venezuela where the Maracaibo Basin contains one of the largest petroleum reserves in the world. Colombia has several productive basins, the two most prolific being the Llanos Basin and the Magdalena Basin. The Abanico Block is located in the Upper Magdalena Basin and contains a number of large fields such as Purification, Venganza, Revancha, Capachos, La Hocha and Guando. The Guando Field, developed by Braspetro and Nexen, is located a few miles from the Abanico Block. Guando is the third largest oilfield discovered in Colombia in the past twenty years and the largest since BP discovered the Cusiana-Cupiagua fields in 1989. Proved reserves at Guando are in excess of 100 million barrels of 28° API crude oil.

Key Facts

Colombia is located in South America, between Panama, the Pacific Ocean and the Caribbean Sea to the north, Ecuador and Peru to the south, and Brazil and Venezuela to the East.

Area:	1,138,910 square kilometres (slightly less than three times the size of Montana)
Coastline:	3,208 kilometres (Caribbean Sea 1,760 km, North Pacific Ocean 1,448 km)
Highest Point:	Pico Cristobal Colon 5,775 m (Andes Mountains)
Population:	Approximately 43 million
Median Age:	Approximately 26 years
Language:	Spanish
Literacy:	92.5%
Religions:	Roman Catholic 90%, other 10%
Government:	Republic; executive branch dominates government structure
Capital:	Bogota (~7,100,000)

Economic Overview

Colombia's economy continues to improve thanks to austere government budgets, focused efforts to reduce public debt levels and an export-oriented growth focus. New exploration is needed to offset declining oil production. Several international financial institutions have praised the economic reforms introduced by the current government which include measures designed to reduce the public-sector deficit below 2.5% of GDP. The government's economic policy and democratic security strategy have engendered a growing sense of confidence in the economy, particularly within the business sector.

SLOVENIA

Key Facts

Slovenia is located in south-central Europe, north of Croatia, west of Hungary, south of Austria and east of both Italy and the northern part of the Adriatic Sea. Historical ties to Western Europe, a strong economy and a stable democracy have all contributed to the transformation of Slovenia into a modern capitalist state since it achieved independence in 1991. Slovenia joined NATO in April, 2004 and became a member of the European Union ("EU") on May 1, 2004.

Area:	20,273 square kilometres (slightly smaller than New Jersey, USA)
Coastline:	47 kilometres
Highest Point:	2,864 metres (Slovenian Alps)
Population:	Approximately 2 million
Median Age:	Approximately 40 years
Language:	Mostly Slovene (German & Croatian widely understood)
Literacy:	100%
Religions:	Roman Catholic 71%, Muslim 1%, Other 28%
Government:	Parliamentary democracy
Capital:	Ljubljana (~270,000)

Economic Overview

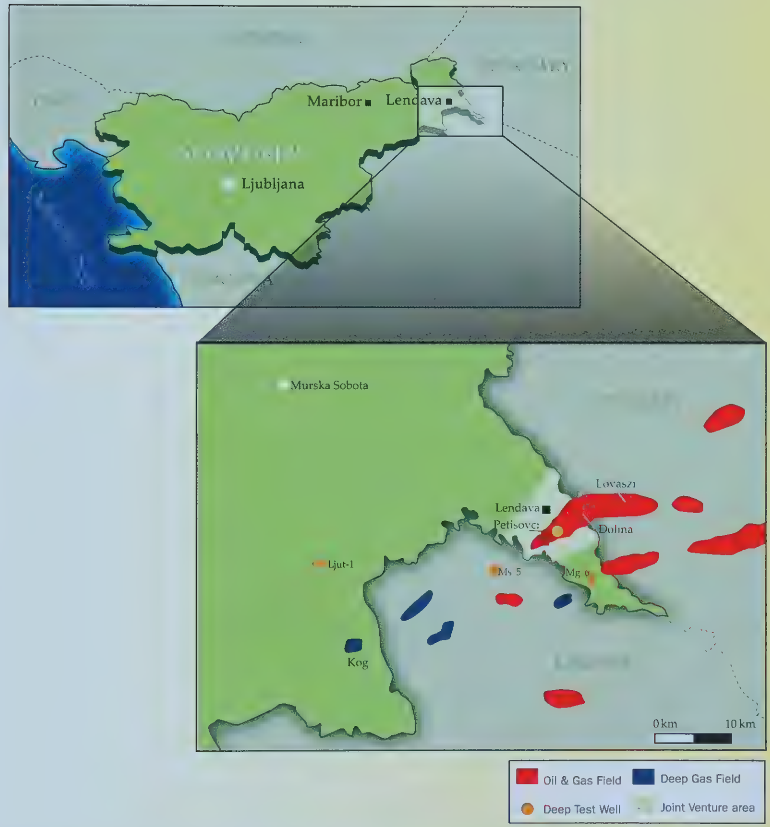
With historical ties to Western Europe, Slovenia enjoys a GDP per capita substantially higher than that of the other transitioning economies of Central Europe. Despite the economic slowdown in Europe in the 2001 to 2003 period, Slovenia maintained growth of 3%. Structural reforms, which improved the business environment and allowed for greater foreign participation in Slovenia's economy, have helped to lower unemployment. The emerging economy consumes hydrocarbons at a rate of more than 50,000 barrels of oil per day and more than 1 billion cubic metres per year of natural gas. Essentially 100% of oil and gas consumption is imported. No withholding tax on repatriation of funds and no restrictions on money flow.

Petisovci and Dolina Fields

The Petisovci and Dolina fields are located in northeastern Slovenia between the border with Hungary and the border with Croatia. Loon is party to a joint venture agreement covering both of these field areas. The fields occur on the Lovaszi anticline, a large structure with a length of 18 kilometres and a width of about 4 kilometres which straddles the border between Slovenia and Hungary. Approximately 35% of the structure is in Slovenia. The Lovaszi field on the Hungarian side of the structure has produced 50 million barrels of oil and more than 230 Bcf of gas since its discovery in 1942. This is more than ten times the amount of oil and gas produced from the Petisovci and Dolina fields. Given the materially lower relative recovery on the Slovenian side of the anticline from the same reservoirs the Company and its joint venture partners believe significant quantities of oil and gas remain to be produced from the joint venture lands.

Primary Targets

Primary targets underlying the joint venture lands are the Petisovci, Lovaszi, Ratka and Paka zones above a depth of approximately 2,000 metres and the Petisovci-Globocki ("Pg") zone between approximately 2,000 metres and 3,000 metres in depth.



Interest of Loon

Under the terms of the joint venture, Loon pays 40% of the costs to drill and complete wells and receives 38% of revenues before payout and 30% thereafter. In 2004 we participated in the drilling of two wells in Slovenia. The first well, at Pt-123 is subject to the regular joint venture terms summarized above. In the first quarter of 2004 Loon and its joint venture partners finalized an agreement with Grove Energy Limited under which Grove could acquire 65% of the rights of Loon and its joint venture partners in the deeper gas zones. The D-14 well was subject to this arrangement. Loon has a carried working interest of 10.5% in this well.

BRUNEI

In early February of 2006, a consortium led by Loon as operator and including QAF Brunei Sendirian Berhad was awarded Block L, which covers 2,253 square kilometres (880 square miles) in Brunei Darussalam. Block L is located mostly onshore in the northeastern part of Brunei. The award is subject to the finalization of a Production Sharing Contract between Loon et al and the Brunei National Petroleum Company Sdn Bhd. The first round of discussion occurred in Bandar Seri Begawan, the capital of Brunei, in early March and a second round of discussions occurred during the last week of April. It is premature to speculate on a start date for exploration activity in Brunei or on the components of any exploration program until such time as negotiations are completed and the Production Sharing Contract is signed.

Key Facts

Negara Brunei Darussalam is located in south-east Asia on the northwest coast of the island of Borneo. It has 161 kilometres of coastline on the South China Sea to the north and shares a 381 kilometre border with Malaysia on the west, south and east. Brunei benefits from extensive oil and gas fields, the source of one of the highest per capita GDP's in the world. Brunei is a sultanate and the family of the current Sultan of Brunei has ruled the country for more than six centuries.

Area	5,770 square kilometres
Climate	Tropical (hot, humid, rainy)
Natural Resources	Petroleum, natural gas, timber
Population	Approximately 380,000
Median Age	Approximately 28 years
Language(s)	Malay (official), English, Chinese
Capital	Bandar Seri Begawan
Government	Sultanate
GDP per capital	~US$24,000

Economic Overview

Crude oil and natural gas production account for nearly half of GDP and more than 90% of government revenues. Substantial income from overseas investments supplements income from domestic production. The government provides for all medical services and free education through university level and subsidized rice and housing.

The following analysis and discussion is dated April 26, 2006 and is provided by the management of Loon Energy Inc. ("Loon" or the "Company") and should be read in conjunction with the audited consolidated financial statements for the years ended December 31, 2005 and 2004.

Basis of Presentation – The financial data presented below has been prepared in accordance with Canadian generally accepted accounting principles. The reporting and the measurement currency is the Canadian dollar.

Non-GAAP Measures – The Management's Discussion and Analysis contains the term "Funds from operations", which should not be considered an alternative to, or more meaningful than cash flow from operating activities as determined in accordance with Canadian generally accepted accounting principles as an indicator of the Company's performance. The Company's determination of funds from operations may not be comparable to that reported by other companies. The reconciliation between net earnings and funds from operations can be found in the consolidated statements of cash flows in the unaudited interim consolidated financial statements and the audited consolidated financial statements. The Company also presents cash flow from operations per unit whereby per unit amounts are calculated using weighted average shares outstanding consistent with the calculation of earnings per share.

BOE Presentation – Barrels of oil equivalent may be misleading, particularly if used in isolation. A BOE conversion ratio of 6 Mcf : 1 bbl oil is based on an energy equivalency conversation method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead. All BOE conversions in this report are derived by converting gas to oil in the ratio of six thousand cubic feet of gas to one barrel of oil.

Summary of Information per BOE

	Year Ended December 31, 2005	Year Ended December 31, 2004
	$	$
Gross Revenue	46.35	35.68
Royalties, Net of ARTC	5.28	2.48
Net Revenue	41.07	33.20
Operating Expense	23.55	19.19
Net Operating Revenue	17.52	14.01
General & Administrative	(85.01)	7.24
Other Income & Foreign Exchange	4.50	–
Interest Expense	2.18	1.08
Cash Flow per boe	(60.81)	5.69

Summary of Information

Loon has production in both Canada and Internationally. Information with respect to international production of the Company at this time, is shown separately.

Financial Overview

	Twelve Months Ended Dec. 31, 2005			Twelve Months Ended Dec. 31, 2004
	Canada	Int'l	Total	Total (1)
	$	$	$	$
Gross Revenue	549,666	142,722	692,388	423,031
Royalties	(41,343)	(37,500)	(78,843)	(29,374)
Net Revenue	508,323	105,222	613,545	393,657
Operating Expense	(230,164)	(121,676)	(351,840)	(227,574)
Net Operating Revenue	278,159	(16,454)	261,705	166,083
General & Administrative Expense	(1,269,885)	–	(1,269,885)	(85,830)
Other Income	67,233	–	67,233	17,164
Interest & Foreign Exchange	(14,253)	46,854	32,601	(12,856)
Funds From Operations	(938,756)	30,400	(908,346)	84,561

(1) All Canadian Production

Oil and Gas Revenues

Oil and gas revenues, before royalties, for the year ended December 31, 2005 was $692,388 compared to $423,031 for the year ended December 31, 2004 – a 63% increase. This was due to a $7.33 per barrel increase in the average oil price, a $2.99 per Mcf increase in the average price of natural gas and an increase of 26% in boe production from 11,856 boe in 2004 to 14,938 in 2005.

	Year Ended December 31, 2005	Year Ended December 31, 2004
Oil and Gas Revenues, Before Royalties	$ 692,385	$ 423,031
Oil and NGL Production (bbls)	10,538	9,936
Oil and NGL Price ($/bbl)	$ 42.75	$ 35.42
Gas Production (Mcf)	26,399	11,522
Gas Price ($/Mcf)	$ 9.16	$ 6.17
BOE Production	14,938	11,856
BOE per Day	41	32

2005 and 2004 Annual Production by Field

	2005			2004		
	Oil	Gas	NGL	Oil	Gas	NGL
CANADA						
Alberta						
Berry	–	11,348	32	–	11,522	40
Grand Forks	5,987	–	–	5,608	–	–
Saskatchewan						
Silverdale	4,519	–	–	4,288	–	–
Total Canada	10,506	11,348	32	9,896	11,522	40
INTERNATIONAL						
Slovenia	–	15,051	–	–	–	–
Total	10,506	26,399	32	9,896	11,522	40

Royalties

Total Canadian royalties, net of ARTC, were $41,343 ($3.32 per BOE) for the year ended December 31, 2005 compared to $29,375 ($2.48 per BOE) for the year ended December 31, 2004. Net royalties represented 7.5% of gross revenues in 2005 compared to 7% in 2004. Alberta Royalty Tax Credit was $2,563 for the year. Total royalties of $78,843 include taxes paid on Slovenia production, are treated as royalties for the purpose of the consolidated financial statements.

	Year Ended December 31, 2005	Year Ended December 31, 2004
	$	$
CANADA		
Crown Royalties	36,679	17,377
Freehold Royalties	3,904	17,979
Gross Overriding Royalties	3,323	2,111
	43,906	37,467
	5,353,517	1,894,921
Alberta Royalty Tax Credit	(2,563)	(8,092)
Net Royalties	41,343	29,374
INTERNATIONAL		
Slovenia Taxes	37,500	–
TOTAL	78,843	29,374
Net Royalties per BOE (6:1)	3.32	2.48
Royalties as Percentage of Revenue	7.5%	7%

Operating Expenses

Operating expenses in calendar 2005 were $351,840 ($23.55 per BOE) compared to $227,574 ($19.19 per BOE) in fiscal 2004. Higher operating costs per BOE were a result of the Slovenia production.

Results per BOE

	Twelve Months Ended Dec. 31, 2005			Twelve Months Ended Dec. 31, 2004
	Canada	Int'l	Total	Total [1]
Production (boe)	12,429	2,509	14,938	11,856
Daily Production (boepd)	34	7	41	32
$/BOE				
Gross Revenue	44.22	56.88	46.35	35.68
Royalties	3.32	14.95	5.28	2.48
Net Revenue	40.90	41.94	41.07	33.20
Operating Expense	18.52	48.49	23.55	19.19
Net Operating Revenue	22.38	(6.56)	17.52	14.01
General & Administrative			(85.01)	(7.24)
Other Income			4.50	1.44
Interest & Foreign Exchange			2.18	(1.08)
Funds From Operations			(60.89)	7.13

(1) All Canadian Production

Depletion, Depreciation and Amortization (DD&A)

Depletion and depreciation was $9,520,184 for the year ended December 31, 2005, which represents a provision of $503.42 per BOE of production. For the year ended December 31, 2004, Loon recorded a DD&A provision of $83,058 ($7.01 per BOE). The provision for 2005 includes a write down of $4,492,214 for Slovenia, a write down of $4,852,500 for Colombia and $175,470 for Canadian properties.

General and Administrative

Gross general and administrative costs have increased from $206,030 in 2004 to $1,269,885 in 2005 due to management fees paid in 2005 where no such fees were paid in prior periods and setting up of an office in Dubai for the company's expanding international activities.

	Year Ended December 31, 2005	Year Ended December 31, 2004
	$	$
Gross General and Administrative	1,269,885	206,030
Overhead Recoveries	–	(120,200)
Net General and Administrative	1,269,885	85,830
Per BOE	85.01	7.24

Provision for Income Taxes

There was no cash income tax provision in 2005 and none is expected in 2006.

Capital Expenditures

Cash and non-cash capital additions for the year ended December 31, 2005 were $6,554,377 compared to $2,095,944 for the year ended December 31, 2004.

	Year Ended December 31, 2005	Year Ended December 31, 2004
	$	$
Canada	59,571	4,193
Slovenia	397,464	2,091,751
Colombia	5,890,879	–
Brunei	206,463	–
Total	6,554,377	2,095,944

Shareholders Equity

The Company issued a total of 23,003,636 common shares in 2005 (22,594,000 shares were issued in 2004). 21,052,636 were issued in a private placement for gross proceeds of 20,000,004 ($0.95 per common share), 351,000 common shares were issued on exercise of stock options and 1,600,000 common shares on the exercise of warrants in 2005. At December 31, 2005 there were 68,733,344 common shares issued. At April 26, 2006, there were 70,911,344 common shares issued.

Related Party Transactions

During the year, the Company sold 10,000 shares of TUSK Energy Corporation for proceeds of $39,400. TUSK Energy Corporation is a shareholder of the Company. The gain on sale of this investment was $29,400.

TUSK Energy Corporation supplies certain personnel and general, accounting and administrative services to the Company for a monthly fee of $6,000.

At December 31, 2005, the Company owed $4,058 to TUSK Energy Corporation and is owed $8,559 (2004 – $8,851) by True Energy Trust. (formerly TKE Energy Trust).

TUSK Energy Corporation purchased 66,500 common shares in the open market for consideration of $54,260 during the quarter ended March 31, 2005 and acquired 3,475,836 common shares of the Company through the private placement for $3,302,046 on March 31, 2005. As of December 31, 2005 TUSK Energy Corporation holds 12,658,275 common shares of the Company.

In February 2005 the Company sold 10,000 units of TKE Energy Trust, purchased at a cost of $99,968 for net proceeds of $107,930.

One individual, who is an officer and a director of the Company, is also an officer and director of TUSK Energy Corporation and a director of True Energy Trust. One director of the Company is an officer of TUSK Energy Corporation.

Two individuals, one a director and one director and officer of the Company acquired a total of 3,050,000 common shares through the private placement.

Nemmoco Petroleum Corporation, a private British Virgin Islands company 25 percent owned by an officer and director of the Company, provides certain personnal and general, accounting and administrative services to the Company on a cost sharing basis.

One director and officer and one director received management fees during the second quarter of 2005 in the amount of $348,621 (2004 – $nil).

Liquidity and Capital Resources

Loon had working capital of $12,018,017 at December 31, 2005 (2004 – $476,396).

On March 31, 2005 Loon closed a private placement of 21,052,636 common shares at $0.95 per share to raise gross proceeds of $20,000,004. Net proceeds from the financing will be used for the Company's capital programs and for general corporate purposes.

On an ongoing basis Loon will typically utilize three sources of funding to finance its capital expenditure program: internally generated funds from operations, debt where deemed appropriate and new equity issues if available on favourable terms. When financing corporate acquisitions, Loon may also assume certain future liabilities. Commodity prices and production volumes have the largest impact on Loon's ability to generate adequate funds to meet all its obligations. A prolonged decrease in commodity prices would negatively affect Loon's funds from operations and would also likely result in a reduction in the amount of bank loan available. If Loon's capital expenditure program does not result in sufficient additional reserves and/or production if would likely have a negative impact on Loon's liquidity.

Loon may adjust its capital expenditure program depending on the commodity price outlook. Loon believes that internally generated funds and incremental bank debt should be sufficient to finance current operations and planned capital spending in the next year.

Business Risks

The marketability and price of products owned or that may be acquired or discovered by Loon will be affected by numerous factors beyond the Company's control. Loon must compete in all aspects of its operations with a number of other corporations that have equal or greater technical or financial resources. The ability of the Company to market its natural gas may depend on its ability to acquire space in pipelines that deliver natural gas to commercial markets. The Company is also subject to market fluctuations in the prices of products, exchange rates, uncertainties related to the proximity of its reserves to pipelines and processing facilities and extensive government regulation.

Quarterly Data

The following tables set forth selected quarterly financial information for the last eight financial quarters.

	Fourth Quarter 2005	Third Quarter 2005	Second Quarter 2005	First Quarter 2005
Production per Day				
Oil and NGLs (bbls)	30	32	29	25
Natural Gas (Mcf)	49	77	64	101
Boe's	38	45	40	41
Netback per boe ($)	6.62	24.79	15.35	21.70
Petroleum and natural gas sales, net ($)	162,159	186,060	136,795	128,531
Funds from operations ($)	(571,842)	102,637	(438,523)	(618)
Net income (loss)	(8,597,821)	(902,999)	(1,884,284)	(153,211)
Per Common Share (basic) ($)	(0.14)	(0.02)	(0.03)	0.00
Per Common Share (diluted) ($)	(0.14)	(0.02)	(0.03)	0.00

	Fourth Quarter 2004	Third Quarter 2004	Second Quarter 2004	First Quarter 2004
Production per Day				
Oil and NGLs (bbls)	30	26	22	40
Natural Gas (Mcf)	38	40	18	30
Boe's	37	33	25	45
Netback per boe ($)	52.20	(13.21)	(35.42)	6.72
Petroleum and natural gas sales, net ($)	101,843	114,854	82,900	94,060
Funds from operations ($)	177,675	(39,504)	(80,842)	27,232
Net income (loss)	29,302	(316,444)	(139,462)	(14,468)
Per Common Share (basic) ($)	0.00	(0.01)	0.00	0.00
Per Common Share (fully diluted) ($)	0.00	(0.01)	0.00	0.00

Fourth Quarter Analysis

	Q4 2005	Q3 2005	Q4 2004
Daily Production			
Oil and NGLs, bpd	30	32	30
Natural Gas, Mcfd	49	77	38
BOEPD	38	45	37
Summary of Product Prices			
Oil and NGLs per bbl	$ 40.23	$ 53.65	$ 33.61
Gas per MCF	$ 15.21	$ 6.69	$ 5.11
Financial			
Oil and Gas Revenues, net	161,136	187,083	101,843
Other Income	12,040	8,858	16,076
Operating Costs	139,201	83,864	12,280
Interest on Long-Term Debt	–	–	–
General and Administrative	611,565	38,404	(72,036)
Depletion, Depreciation and Accretion	7,746,986	863,502	34,373
Financing Cost	–	–	114,000
Stock-Based Compensation	278,993	38,404	–
Funds from Operations	(571,842)	(102,637)	177,675
Net Income (Loss)	(8,597,821)	(902,999)	29,302
Per Common Share Basic	(0.14)	(0.02)	0.00
Per Common Share Diluted	(0.14)	(0.02)	0.00

General and Administrative

G&A in Q4 2005 was $611,565. The increase in G&A costs was due to setting up of an office in Dubai.

Depletion, Depreciation and Accretion

Write downs in the fourth quarter of $1,947,214 for Slovenia and $4,852,500 for Colombia resulted in higher depletion, depreciation and accretion in the fourth quarter.

Refer to the 2005 compared to 2004 MD&A for explanations for other variances.

Commitments

On April 13, 2005, the Company announced a joint venture agreement with a Colombian company whereby Loon has agreed to expend a minimum of US$6 million to earn a 49% working interest in certain of the Colombian company's properties in Colombia. To the end of December 31, 2005, approximately US$4.8 million of the commitment had been expended.

Subsequent Events

a) On February 7, 2006 the Company announced that a consortium led by Loon and a Brunei Company, had been awarded Block L which covers 2,253 square kilometers (880 square miles) by Brunei National Petroleum Company Sendirian Berhad ("PetroleumBRUNEI") in Negara Brunei Darussalam (Brunei). The Block is located mostly onshore but partly offshore on the northeastern part of Brunei. The award is subject to the finalization of a Production Sharing Contract between Loon et al and PetroleumBRUNEI.

   Loon commenced its initial evaluation of the potential of Block L during the middle of 2005 and submitted its proposal on January 3, 2006.

   Brunei Darussalam is located in south-east Asia on the northern coast of the island of Borneo. It occupies a total area of 5,770 square kilometres of which 5,270 square kilometres is land.

b) On April 18, 2006 Proprietary Industries Inc., a public company traded on the Toronto Stock Exchange ("Proprietary") and Loon Energy Inc. ("Loon") announced that Proprietary had acquired all of the issued and outstanding shares of Frontier Holdings Limited ("Frontier") from Loon and from Nemmoco Petroleum Limited a third party private Bermuda Company ("Nemmoco", and together with Loon, the "Vendors"). Prior to the acquisition of such shares, each of Loon and Nemmoco owned 50% of Frontier. Frontier, a private Bermuda company, is a party to a series of farm-in agreements, which, subject to the approval of various government agencies, involve the acquisition by Frontier (collectively, with the purchase and sale of the Frontier shares, the "Acquisition") of the following oil and gas interests in Asia:

   - a 37.5% interest in a development and production lease (the "Development and Production Lease") covering a gas field; and
   - a 47.5% to 50% interest in five exploration blocks.

   As consideration for the shares of Frontier, Proprietary has issued and deposited into escrow, an aggregate of 14,958,838 common shares of Proprietary (the "Proprietary Shares"). The Proprietary Shares will be released from escrow (the "Escrow Release") and distributed to the Vendors, 7,479,419 to each of Loon and Nemmoco, upon receipt of the necessary government approval for the Acquisition which is currently expected to occur within 120 days. In addition, Proprietary has agreed to issue to the Vendors an aggregate of an additional 500,000 Proprietary Shares (250,000 to each of Loon and Nemmoco) for each 100 billion cubic feet of reserves of gas proven during the 5 years following the Escrow Release, up to a maximum of an aggregate of an additional 7,681,918 Proprietary Shares, in each case, subject to regulatory approval. In certain circumstances, Proprietary may be required to pay cash to the Vendors in lieu of issuing such additional Proprietary Shares.

   In connection with the Acquisition, subject to the Escrow Release, Proprietary has granted options to acquire an aggregate of 4.3 million Proprietary Shares to certain directors, officers and employees of Frontier who will have key roles in the project.

   The Frontier agreements call for payments to be made in respect of the reimbursement of prior expenses and finder's fees together with the obligation by Frontier to fund, in varying amounts, 10 exploration wells and 7 development wells over the next 36 months.

   Total expenditures by Frontier in respect of the foregoing are currently expected to be approximately US$60 million during such period.

   In the event the government approvals are not obtained within 120 days, the Acquisition will be unwound, the Frontier shares will be returned to the Vendors and the Proprietary Shares will be returned to Proprietary and cancelled.

Disclosure Controls and Procedures

Disclosure controls and procedures have been designed to ensure that information required to be disclosed by the company is accumulated and communicated to the Company's management as appropriate to allow timely decisions regarding disclosure. The Company's Chief Executive Officer and Chairman have concluded, based on their evaluation as of the end of the period covered by the Company's annual filings for the most recently completed financial year, that the Company's disclosure controls and procedures as of the end of such period are effective to provide reasonable

assurance that material information related to the Company, including its consolidated subsidiaries, is made known to them by others within those entities. It should be noted that while the Company's Chief Executive Officer and Chairman believe that the Company's disclosure controls and procedures provide a reasonable level of assurance that they are effective, they do not expect that the disclosure controls and procedures will prevent all errors and fraud. A control system, not matter how well conceived or operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met.

Outlook

The Company will continue to focus its exploration and development efforts on international locations, including Colombia, Brunei and other geographic areas.

Application of Critical Accounting Estimates

The significant accounting policies used by Loon are disclosed in note 2 to the consolidated financial statements. Certain accounting policies require that management make appropriate decisions with respect to the formulation of estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. The following discusses such accounting policies and is included in Management's Discussion and Analysis to aid the reader in assessing the critical accounting policies and practices of the Company and the likelihood of materially different results being reported. Loon's management reviews its estimates regularly. The emergence of new information and changed circumstances may result in actual results or changes to estimated amounts that differ materially from current estimates.

The following assessment of significant accounting policies is not meant to be exhaustive. The Company might realize different results from the application of new accounting standards promulgated, from time to time, by various rule-making bodies.

Oil and Gas Reserves

Under NI 51-101, "Proved" reserves are those reserves that can be estimated with a high degree of certainty to be recoverable (it is likely that the actual remaining quantities recovered will exceed the estimated Proved reserves). In accordance with this definition, the level of certainty targeted by the reporting company should result in at least a 90 percent probability that the quantities actually recovered will equal or exceed the estimated reserves. There was no such consideration of probability under the Canadian Securities Administrators' National Policy 2-B ("NP-2B"). In the case of "Probable" reserves, which are obviously less certain to be recovered than Proved reserves, NI 51-101 states that it must be equally likely that the actual remaining quantities recovered will be greater or less than the sum of the estimated Proved plus Probable reserves. With respect to the consideration of certainty, in order to report reserves as Proved plus Probable, the reporting company must believe that there is at least a 50 percent probability that the quantities actually recovered will equal or exceed the sum of the estimated Proved plus Probable reserves. The implementation of NI 51-101 has resulted in a more rigorous and uniform standardization of Reserve evaluation.

The oil and gas reserve estimates are made using all available geological and reservoir data as well as historical production data. Estimates are reviewed and revised as appropriate. Revisions occur as a result of changes in prices, costs, fiscal regimes, reservoir performance or a change in the Company's plans. The effect of changes in proved oil and gas reserves on the financial results and position of the Company is described under the heading "Full Cost Accounting for Oil and Gas Activities".

Proved plus Probable (or "2P") reserves as defined in NI 51-101 are viewed by many industry participants as being comparable to the "Established" reserves definition that was used historically. The 2P reserves form the basis for calculation of reserve life indices and are considered as the more accurate estimate of the actual reserves quantities.

Full Cost Accounting for Oil and Gas Activities

Depletion Expense

The Company uses the full cost method of accounting for exploration and development activities. In accordance with this method of accounting, all costs associated with exploration and development are capitalized whether successful or not. The aggregate of net capitalized costs and estimated future development costs less estimated salvage values is depleted using the unit-of-production method based on estimated proved oil and gas reserves.

An increase in estimated proved oil and gas reserves would result in a corresponding reduction in depletion expense. A decrease in estimated future development costs would result in a corresponding reduction in depletion expense.

Withheld Costs

Certain costs related to unproved properties including international assets, are excluded from costs subject to depletion until proved reserves have been determined or their value is impaired. These properties are reviewed quarterly and any impairment is transferred to the costs being depleted or, if the properties are located in a cost centre where there is no reserve base, the impairment is charged directly to earnings.

Full Cost Accounting Ceiling Test

The carrying value of oil and gas properties is reviewed at least annually for impairment. Impairment occurs when the carrying value of the assets is not recoverable by the future undiscounted cash flows. The cost recovery ceiling test is based on estimates of proved reserves, production rate, future petroleum and natural gas prices, future costs and other relevant assumptions. By their nature, these estimates are subject to measurement uncertainty and the impact on the financial statements could be material. Any impairment would be charged as additional depletion and depreciation expense.

Impairment of Long-Lived Assets

The Company is required to review the carrying value of all property, plant and equipment, including the carrying value of oil and gas assets, for potential impairment. Impairment is indicated if the carrying value of the long-lived asset or oil and gas cost centre is not recoverable by the future undiscounted cash flows. If impairment is indicated, the amount by which the carrying value exceeds the estimated fair value of the long-lived asset is charged to earnings.

Asset Retirement Obligations

The Company records a liability for the fair value of legal obligations associated with the retirement of long-lived tangible assets in the period in which they are incurred, normally when the asset is purchased or developed. On recognition of the liability there is a corresponding increase in the carrying amount of the related asset known as the asset retirement cost, which is depreciated on a straight-line basis over the life of the reserves. The liability is adjusted each reporting period to reflect the passage of time, with the accretion charged to earnings, and for revisions to the estimated future cash flows. Actual costs incurred upon settlement of the obligations are charged against the liability.

Income Tax Accounting

The determination of the Company's income and other tax liabilities requires interpretation of complex laws and regulations often involving multiple jurisdictions. All tax filings are subject to audit and potential reassessment after the lapse of considerable time. Accordingly, the actual income tax liability may differ significantly from that estimated and recorded by management.

Legal, Environmental Remediation and Other Contingent Matters

The Company is required to both determine whether a loss is probable based on judgment and interpretation of laws and regulations and determine that the loss can reasonably be estimated. When the loss is determined it is charged to earnings. The Company's management must continually monitor known and potential contingent matters and make appropriate provisions by charges to earnings when warranted by circumstance.

Stock Based Compensation Plan

The Company applies the fair value method for valuing stock option and warrant grants. Under this method, compensation cost, attributable to options and warrants granted to employees, contractors, officers and directors of Loon is measured at fair value at the grant date and expensed with a corresponding increase to contributed surplus. Upon the exercise of the options, consideration paid together with the amount previously recognized in contributed surplus is recorded as an increase to share capital.

The Company has not incorporated an estimated forfeiture rate for stock options, rather the Company accounts for actual forfeiture as they occur.

Additional Information

Additional information regarding the Company and its business and operations is available on the Company's profiles at www.sedar.com. Copies of the information can also be obtained by contacting the Company at Loon Energy Inc. 1950, 700 – 4th Avenue S.W., Calgary, Alberta T2P 3J4 (Phone: 403-264-8877) or by e-mail at mwiltshire@loon-energy.com. This information is also accessible on the Company's website at www.loon-energy.com.

Forward Looking Statements

Certain information regarding Loon set forth in the document, including management's assessment of Loon's future plans and operations, contain forward looking statements that involve substantial known and unknown risks and uncertainties. These forward looking statements are subject to numerous risks and uncertainties, certain of which are beyond Loon's control, including the impact of general imprecision of reserve estimates, environmental risks, taxation policies, competition from other producers, the lack of availability of qualified personnel or management, stock market volatility and the ability to access sufficient capital from internal or external sources. Loon's actual results, performance or achievement could differ materially from those expressed in, or implied by, these forward looking statements and, accordingly, no assurance can be given that any of events anticipated by the forward looking statements will transpire or occur, or if any of them do so, what benefits that Loon will derive therefrom.

FINANCIAL INFORMATION

MANAGEMENT'S REPORT

To the Shareholders of Loon Energy Inc.

Management is responsible for the accompanying consolidated financial statements and all other information in this annual report. The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles and necessarily include amounts that reflect management's judgement and best estimates. Financial information contained elsewhere in this annual report is consistent with the consolidated financial statements.

Management has established systems of internal control that provide reasonable assurance that the consolidated financial statements realistically report the Company's operating and financial results and that assets are safeguarded from loss or unauthorized use.

The Board of Directors is responsible for all aspects related to governance of the Company. The Audit Committee of the Board has a specific responsibility for reviewing management's responsibilities for financial reporting and internal controls related thereto. The Audit Committee meets with management and independent auditors to review the consolidated financial statements and the internal controls as they relate to financial reporting. The Audit Committee reports its findings to the Board for its consideration in approving the consolidated financial statements for issuance to the shareholders.

KPMG LLP, appointed by the shareholders as the Company's independent auditors, conducts an examination of the consolidated financial statements in accordance with Canadian generally accepted auditing standards.

"signed"

Timothy M. Elliott
President and Chief Executive Officer

"signed"

Norman W. Holton
Chairman

April 26, 2006

AUDITORS' REPORT

To the Shareholders of Loon Energy Inc.

We have audited the consolidated balance sheets of Loon Energy Inc. as at December 31, 2005 and 2004 and the consolidated statements of operations and deficit and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and the disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated statements present fairly, in all material respects, the financial position of the Company as at December 31, 2005 and 2004 and the results of its operations and cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

"signed"

KPMG LLP
Chartered Accountants

Calgary, Canada
April 26, 2006

CONSOLIDATED BALANCE SHEETS

As at December 31, 2005 and 2004	2005	2004
	$	$
ASSETS		
Current		
Cash	3,881,442	127,016
Accounts Receivable	337,561	622,606
Short Term Investments (Note 3)	7,934,720	124,800
Prepaid Expenses and Deposits	109,604	22,728
	12,263,327	897,150
Property, Plant and Equipment (Note 5)	1,669,643	4,625,952
	13,932,970	5,523,102
LIABILITIES		
Current		
Accounts Payable and Accrued Liabilities	245,310	420,754
Asset Retirement Obligations (Note 4)	164,273	64,775
SHAREHOLDER'S EQUITY		
Capital Stock (Note 7)	24,376,736	5,462,392
Contributed Surplus (Note 7)	1,428,785	319,000
Deficit	(12,282,134)	(743,819)
	13,523,387	5,037,573
	13,932,970	5,523,102

Future Operations (Note 1)

Commitments (Note 13)

Subsequent Events (Note 14)

See Accompanying Notes

Approved by the Board:

"signed"

Norman W. Holton
Director

"signed"

Michael A. McVea
Director

CONSOLIDATED STATEMENTS OF OPERATIONS AND DEFICIT

For the years ended December 31, 2005 and 2004	2005	2004
	$	$
Oil and Gas Revenues	692,388	423,031
Royalties	(78,843)	(29,374)
Other Income	67,233	17,164
	680,778	410,821
Expenses		
Operating	351,840	227,574
General and Administrative	1,269,885	85,830
Interest on Long Term Debt	14,253	12,856
Stock-Based Compensation (Note 7)	1,109,785	323,000
Gain on Foreign Exchange	(46,854)	–
Financing Cost (Note 6)	–	114,000
Depletion, Depreciation and Accretion (Note 5)	9,520,184	88,633
	12,219,093	851,893
Net Loss Before Income Taxes	(11,538,315)	(441,072)
Income Taxes (Note 8)	–	–
Net Loss For the Year	(11,538,315)	(441,072)
Deficit; Beginning of Year	(743,819)	(302,747)
Deficit; End of Year	(12,282,134)	(743,819)
Loss Per Share, Basic and Diluted	(0.19)	(0.01)

See Accompanying Notes

CONSOLIDATED STATEMENTS OF CASH FLOWS

For the years ended December 31, 2005 and 2004	2005	2004
	$	$
Net Inflow (outflow) of Cash Related to the following Activities:		
Operating		
Net Loss For the Year	(11,538,315)	(441,072)
Item not Affecting Cash		
Depletion, Depreciation and Accretion	9,520,184	88,633
Stock-Based Compensation	1,109,785	323,000
Financing Cost	–	114,000
Future Income Taxes	–	–
	(908,346)	84,561
Changes in Non-cash Operating		
Working Capital Items (Note 9)	22,725	(378,331)
	(885,621)	(293,770)
Financing		
Issue of Share Capital	20,000,004	1,819,500
Share Issue Costs	(1,298,310)	(11,025)
Stock Options Exercised	52,650	–
Warrants Exercised	160,000	–
	18,914,344	1,808,475
Investing		
Short Term Investments	(7,809,920)	–
Property, Plant and Equipment	(6,464,377)	(1,435,944)
	(14,274,297)	(1,435,944)
Net Cash Inflow	3,754,426	78,761
Cash; Beginning of Year	127,016	48,255
Cash; End of Year	3,881,442	127,016
Interest Paid	14,253	66,358
Interest Received	13,630	17

See Accompanying Notes

DECEMBER 31, 2005 AND DECEMBER 31, 2004

1. FUTURE OPERATIONS

The recovery of petroleum and natural gas property costs capitalized is dependent on Loon Energy Inc.'s ("Loon or the Company") ability to generate profitable operations.

2. SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles, where necessary, the consolidated financial statements include amounts based on informed estimates and best judgments of management.

a) *Principles of Consolidation*

The financial statements consolidate the accounts of the Company and its wholly owned subsidiaries, Zama Energy Ltd. and Loon Energy Limited (a Cyprus Company).

b) *Petroleum and Natural Gas Properties*

The Company follows the full cost method of accounting for petroleum and natural gas operations, whereby all costs related to the acquisition, exploration and development of petroleum and natural gas reserves are capitalized within costs centres on a country by country basis. All such costs are accumulated in cost centres representing the Company's activities undertaken in Canada, Slovenia, Colombia and other. Such costs include lease acquisition costs, geological and geophysical costs, carrying charges of non-producing properties, costs of drilling both productive and non-productive wells, the cost of petroleum and natural gas production equipment and overhead charges related to exploration and development activities.

Petroleum and natural gas assets are evaluated at least annually to determine that the costs are recoverable and do not exceed the fair value of the assets. The costs are assessed to be recoverable if the sum of the undiscounted cash flows expected from the production of proved reserves and the lower of cost and market of unproved properties exceed the carrying value of the petroleum and natural gas assets. If the carrying value of the petroleum and natural gas assets is not assessed to be recoverable, an impairment loss is recognized to the extent that the carrying value exceeds the sum of the discounted cash flows expected from the production of proved and probable reserves and the lower of cost and market of unproved properties. The cash flows are estimated using the future product prices and costs are discounted using the risk-free rate. Proceeds from the disposition of petroleum and natural gas properties are applied against capitalized costs except for dispositions that would change the rate of depletion and depreciation by 20% or more, in which case a gain or loss would be recorded.

Costs of acquiring and evaluating significant unproved petroleum and natural gas interests are excluded from costs subject to depletion and depreciation until it is determined that proved reserves are attributable to such interest or until impairment occurs.

c) *Depletion and Depreciation*

Capitalized costs, together with estimated future capital costs associated with proved reserves, are depleted and depreciated using the unit-of-production method based on estimated gross proved reserves of petroleum and natural gas as determined by independent engineers. For purposes of this calculation, reserves and production are converted to equivalent units of oil based on relative energy content of six thousand cubic feet of gas to one barrel of oil. Costs of significant unproved properties, net of impairments, are excluded from the depletion and depreciation calculation.

d) *Asset Retirement Obligations*

The Company records a liability for the fair value of legal obligations associated with the retirement of long-lived tangible assets in the period in which they are incurred, normally when the asset is purchased or developed. On recognition of the liability there is a corresponding increase in the carrying amount of the related asset known as the asset retirement cost, which is depleted on a straight line basis over the life of the proved reserves. The liability is adjusted each reporting period to reflect the passage of time, with the accretion charged to earnings, and for revisions to the estimated future cash flows. Actual costs incurred upon settlement of the obligations are charged against the liability.

e) *Revenue Recognition*

Revenues from the sale of petroleum and natural gas are recorded when title passes to an external party.

f) *Transportation Expenses*

Transportation expenses are presented as an expense in the Statement of Operations and Deficit, within operating expenses.

g) Joint Operations

Substantially all of the Company's oil and gas activities are conducted jointly with others. The accounts reflect only the Company's proportionate interest in such activities.

h) Measurement Uncertainty

The amounts recorded for depletion and depreciation of property, plant and equipment and the provision for asset retirement obligations are based on estimates. The ceiling test is based on such factors as estimated proved reserves, production rates, oil and natural gas future prices, future costs and other relevant assumptions. By their nature, these estimates are subject to measurement uncertainty and the impact on the financial statements of future periods is uncertain.

i) Income Taxes

The Company uses the asset and liability method of accounting for income taxes. Under this method, future tax assets and liabilities are recognized for the future consequences attributable to differences between the financial statements carrying amounts of existing assets and liabilities and their respective tax bases. Future tax assets and liabilities are measured using enacted or substantively enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on future tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the date of enactment or substantive enactment. A valuation allowance is recorded against any future income tax asset if it is more likely than not that the asset will not be realized.

j) Per Share Amounts

Basic per share amounts are calculated using the weighted average number of shares outstanding during the year. Weighted average number of shares is determined by relating the portion of time within the reporting period that common shares have been outstanding to the total time in that period. Diluted per share amounts are calculated based on the treasury stock method which assumes that any proceeds, obtained on exercise of options and warrants would be used to purchase common shares at the average market price during the period. The weighted average number of shares outstanding is then adjusted by the net change.

k) Stock Based Compensation Plan

The Company used the fair value method for valuing stock option and warrant grants. Under this method, compensation costs, attributable to share options and warrants granted to employees, contractors, officers and directors of Loon are measured at fair value at the grant date and expensed with a corresponding increase to contributed surplus. Upon the exercise of the stock options, consideration paid together with the amount previously recognized in contributed surplus is recorded as an increase to share capital.

The Company has not incorporated an estimated forfeiture rate for stock options, rather, the Company accounts for an actual forfeiture as they occur.

l) Foreign Currency Translation

The Company incurs various expenses which result in monetary assets and liabilities denominated in U.S. dollars. These U.S. dollar denominated balances are translated to Canadian dollars at exchange rates in effect at the balance sheet date, with the resulting gain or loss being recorded in the income statement. All other translation gains and losses, which relate to the translation of U.S. dollar denominated accounts receivable and accounts payable, are classified as realized since they are settled in less than one year.

m) Comparative Figures

Certain comparative figures have been reclassified to conform with the current financial statement basis of presentation.

3. SHORT TERM INVESTMENTS

Short term investments include a banker's acceptance note with the National Bank of Canada entered into in December 2005. On maturity (March 13, 2006) Loon will receive $8,000,000.

4. ASSET RETIREMENT OBLIGATIONS

The Company's asset retirement obligations result from net ownership interests in petroleum and natural gas assets including well sites, gathering systems and processing facilities. The Company estimates the total undiscounted amount of cash flows required to settle its asset retirement obligations is approximately $212,471 (2004 – $117,000) which will be incurred between 2005 and 2029. The majority of the costs will be incurred between 2008 and 2020. A credit-adjusted risk-free rate of 9.0 percent and an inflation rate of 2.0 percent were used to calculate the fair value of the asset retirement obligations.

A reconciliation of the asset retirement obligations is provided below:

	Year Ended December 31, 2005	Year Ended December 31, 2004
Balance, beginning of year	64,775	59,200
Liabilities incurred	90,000	–
Accretion expense	9,498	5,575
Balance, end of year	164,273	64,775

5. PROPERTY, PLANT AND EQUIPMENT

	December 31, 2005		
	Cost	Accumulated Depletion & Depreciation	Net Book Value
	$	$	$
Oil and Gas Properties – Canada	2,673,615	2,339,255	334,360
Oil and Gas Properties – Slovenia	4,542,214	4,492,214	50,000
Oil and Gas Properties – Colombia	5,890,879	4,852,500	1,038,379
Oil and Gas Properties – Other	206,463	–	206,463
Office Equipment	57,316	16,875	40,441
	13,370,487	11,700,844	1,669,643

	December 31, 2004		
	Cost	Accumulated Depletion & Depreciation	Net Book Value
	$	$	$
Oil and Gas Properties - Canada	2,661,614	2,181,158	480,456
Oil and Gas Properties – Slovenia	4,144,750	–	4,144,750
Office Equipment	9,746	9,000	746
	6,816,110	2,190,158	4,625,952

The Colombian and Other cost centres are in the pre-production stage and therefore the recovery of the costs outlined above is dependent on the Company achieving commercial production or sale and/or obtaining additional financing.

The provision for depletion & depreciation includes a write down of $4,492,214 for Slovenia and $4,852,500 for Colombia.

The Company performed a ceiling test calculation at December 31, 2005 for the Canadian cost centre resulting in the undiscounted cash flows from proved reserves properties exceeding the carrying value of oil and gas assets. The following table summarizes the future benchmark prices the Company used in the ceiling test for the Canadian cost centre, adjusted for the Company's differentials:

	Crude Oil		Natural Gas
	West Texas (US$/bbl)	Edmonton (Cdn$/bbl)	AECO (Cdn$/mmbtu)
2006	59.00	68.91	9.80
2007	58.00	67.74	8.86
2008	56.00	65.38	8.36
2009	54.00	63.03	7.85
2010	52.00	60.68	7.60
2011	50.00	58.32	7.35
Thereafter	1.5%	1.5%	1.5%

1) Future prices incorporated a $0.85 US/Cdn exchange rate for 2006, and thereafter.

No administrative overhead expenditures directly related to the acquisition, exploration and development of petroleum and natural gas reserves have been capitalized in either of the years ended December 31, 2005 or 2004. No interest has been capitalized to oil and gas properties in either of the years ended December 31, 2005 or 2004.

6. LONG-TERM DEBT

On February 27, 2004 the debenture holders agreed to extend the term of the debenture to January 1, 2006. As consideration for the extension, the Company granted the debenture holders an aggregate of 1,600,000 Share purchase warrants which entitled the holders thereof to acquire 1,600,000 common shares of Loon at $0.10 per common share at any time prior to January 1, 2006. The cost of issuing the warrants was calculated using a Black-Scholes model and was determined to be $114,000.

On March 31, 2004, the debenture holders elected to convert their debentures into 8,000,000 common shares of the Company.

7. SHARE CAPITAL

a) Authorized share capital:

Unlimited number of common shares

Unlimited number of preferred shares

b) Issued:

Common shares were issued as follows:

	December 31, 2005		December 31, 2004	
	Number	Amount	Number	Amount
		$		$
Common Shares:				
Balance Beginning of Year	45,729,708	5,348,392	23,135,708	2,059,917
Issued for Cash	21,052,636	20,000,004	9,990,000	1,798,200
Issued on Exercise of Stock Options	351,000	52,650	204,000	41,300
Issued on Exercise of Warrants	1,600,000	274,000	–	–
Issued on Conversion of Long-Term Debt	–	–	8,000,000	800,000
Issued for Purchase of Additional Interest Of Slovenia Property	–	–	4,400,000	660,000
Share Issue Costs	–	(1,488,310)	–	(11,025)
Balance End of Year	68,733,344	24,186,736	45,729,708	5,348,392
Share Purchase Warrants:				
Balance Beginning of Year	1,600,000	114,000	–	–
Issued During the Year	500,000	190,000	1,600,000	114,000
Exercised During the Year	(1,600,000)	(114,000)	–	–
Balance End of Year	500,000	190,000	1,600,000	114,000
Total		24,376,736		5,462,392

c) Per Share Amounts

Per share amounts have been calculated based on the weighted average number of shares outstanding. The basic and diluted weighted average shares outstanding for the year ended December 31, 2005 was 61,994,015 (2004 – 38,678,064).

d) Stock Options

Stock options, entitling the holder to purchase shares from the Company, have been granted to directors, officers and certain employees of the Company. The stock options vest one-third immediately, one-third on the first and second anniversary of the date of grant. The maximum term on an option is 5 years with exercise prices ranging from $0.10 to $0.95.

Exercise Price	Number	Weighted Average Remaining Life Years
$0.10	1,408,000	0.7
$0.11	250,000	2.1
$0.16	800,000	3.3
$0.21	700,000	3.7
$0.24	700,000	3.7
$0.70	700,000	3.2
$0.95	2,000,000	4.4
	6,558,000	

A summary of the status of the Company's stock option plan as of December 31, 2005 and 2004, and changes during the years then ended are presented below:

	2005		2004	
	Options	Weighted Average Exercise Price ($)	Options	Weighted Average Exercise Price ($)
Outstanding, Beginning of Year	4,209,000	0.16	2,213,000	0.12
Granted	500,000	0.07	2,200,000	0.20
Granted	200,000	0.07	–	–
Granted	2,000,000	0.95	–	–
Exercised	(351,000)	0.15	(204,000)	0.10
Outstanding and Exercisable, End of Year	6,558,000	0.46	4,209,000	0.16

At December 31, 2005, the options granted are estimated on the date of grant using the Black-Scholes option-pricing model. The weighted average fair market value of options granted and the assumptions used in their determination are as noted below:

Stock-based Compensation:

The fair value of all common share options granted are estimated on the date of grant using the Black-Scholes option-pricing model. The weighted average fair market value of options granted during the year ended December 31, 2005 and the assumptions used in their determination are as follows:

	Year Ended December 31, 2005	Year Ended December 31, 2004
Weighted average fair market value per option	0.7112	0.3143
Risk-free interest rate (percent)	3.12	3.16
Volatility (percent)	112.6	149.0
Expected life (years)	5.0	5.0

Contributed Surplus

The following table reconciles the Company's contributed surplus:

	Year Ended December 31, 2005	Year Ended December 31, 2004
Balance, Beginning of Year	319,000	–
Stock Based Compensation Expense	1,109,785	339,000
Common Shares Rights Exercised	–	(20,000)
Balance, End of Year	1,428,785	319,000

8. INCOME TAXES

Income tax expense differs from the amount that would be computed by applying the federal and provincial statutory rate of 37.62% of income before income taxes. The reasons for the differences are as follows:

	Year Ended December 31, 2005	Year Ended December 31, 2004
	$	$
Expected Tax (Recovery) Expense	(4,340,700)	(171,600)
Non-deductible Crown Charges	9,000	6,100
Alberta Royalty Tax Credit	(600)	(2,800)
Resource Allowance	43,100	(7,000)
Stock-Based Compensation	417,500	170,000
Valuation Allowance	3,871,700	5,300
Actual Tax (Recovery) Expense	–	–

The components of the future tax asset at December 31, 2005 and 2004 is as follows:

	Year Ended December 31, 2005	Year Ended December 31, 2004
	$	$
Property, Plant and Equipment	3,363,800	243,600
Share Issue Costs	492,000	57,200
Asset Retirement Obligations	55,200	22,400
Capital Losses Carried Forward	273,200	215,700
Losses Carried Forward	209,500	14,200
	4,393,700	553,100
Less Valuation Allowance	(4,393,700)	(553,100)
	–	–

9. CHANGES IN NON-CASH WORKING CAPITAL

	December 31, 2005	December 31, 2004
	$	$
Short Term Investments	–	(124,800)
Accounts Receivable	285,045	(340,092)
Prepaid Expenses and Deposits	(86,876)	3,942
Accounts Payable and Accrued Liabilities	(175,444)	82,619
	22,725	(378,331)

10. RELATED PARTY TRANSACTIONS

TUSK Energy Corporation supplies certain personnel and general, accounting and administrative service to the Company for a monthly fee of $6,000.

At December 31, 2005 the Company owed $4,058 to TUSK Energy Corporation and is owed $8,559 (2004 – $8,851) by True Energy Trust (formerly TKE Energy Trust).

TUSK Energy Corporation purchased 66,500 common shares in the open market for consideration of $54,260 during the year ended December 31, 2005, acquired 3,475,836 common shares of the Company through the private placement for $3,302,046 on March 31, 2005 and acquired 1,200,000 common shares on the exercise of purchase warrants for $120,000. As of December 31, 2005 TUSK Energy Corporation holds 12,658,275 common shares of the Company.

In February 2005 the Company sold 10,000 units of TKE Energy Trust, purchased at a cost of $99,968 for net proceeds of $107,930.

During the year ended December 31, 2005 the Company sold 10,000 shares of TUSK Energy Corporation for proceeds of $39,400. The gain on sale of this investment was $29,400.

One individual, who is an officer and a director of the Company, is also an officer and director of both TUSK Energy Corporation and a director of True Energy Trust. One director of the Company is an officer of TUSK Energy Corporation.

Two individuals, one a director and one director and officer of the Company acquired a total of 3,050,000 common shares through the private placement.

Nemmoco Petroleum Corporation, a private British Virgin Islands company 25 percent owned by an officer and director of the Company, provides certain personnal and general, accounting and administrative services to the Company on a cost sharing basis.

One director and officer and one director received management fees during the year ended December 31, 2005 in the amount of $348,621 (2004 – nil).

All related party transactions are at normal industry terms and conditions.

11. FINANCIAL INSTRUMENTS

a) Credit Risk

The Company's accounts receivable are with customers and joint venture partners in the petroleum and natural gas business and are subject to normal credit risks. To mitigate this risk, the Company sells substantially all of its production to two primary purchasers under normal industry sale and payment terms. The Company may be exposed to certain losses in the event on non-performance by counterparties to commodity price contracts.

b) Foreign Currency Exchange Risk

The Company is exposed to foreign currency fluctuations as crude oil prices received are referenced in U.S. dollar denominated prices.

c) Fair Value of Financial Instruments

The Company's financial instruments recognized in the balance sheet consist of accounts receivable, short-term investments and accounts payable. The fair value of these financial instruments approximate their carrying amounts due to their short terms to maturity.

12. SEGMENTED INFORMATION

The following represents selected segmented information for the years ended December 31, 2005 and 2004:

	Canada December 31,		International [1] December 31,	
	2005	2004	2005	2004
	$	$	$	$
Operations				
Oil and Gas Revenue	549,666	423,031	142,722	–
Royalties and Taxes	(41,343)	(29,374)	(37,500)	–
Operating Expenses	(230,164)	(227,574)	(121,676)	–
Net Operating Income	278,159	166,083	(16,454)	–
Capital Expenditures [2]	59,571	45,193	6,384,509	1,817,751

(1) All International net operating income for December 31, 2005 was earned in Slovenia.

(2) Refer to Note 5 to the consolidated financial statements for a breakdown of capital expenditures by country.

13. COMMITMENTS

On April 13, 2005, the Company announced a joint venture agreement with a Colombian company whereby Loon has agreed to expend a minimum of US$6 million to earn a 49% working interest in certain of the Colombian company's properties in Colombia. To the end of December 31, 2005, approximately US$4.8 million of the commitment had been expended.

14. SUBSEQUENT EVENTS

a) On February 7, 2006 the Company announced that a consortium led by Loon and a Brunei Company, had been awarded Block L which covers 2,253 square kilometers (880 square miles) by Brunei National Petroleum Company Sendirian Berhad ("PetroleumBRUNEI") in Negara Brunei Darussalam (Brunei). The Block is located mostly onshore but partly offshore on the northeastern part of Brunei. The award is subject to the finalization of a Production Sharing Contract between Loon et al and PetroleumBRUNEI.

Loon commenced its initial evaluation of the potential of Block L during the middle of 2005 and submitted its proposal on January 3, 2006.

Brunei Darussalam is located in south-east Asia on the northern coast of the island of Borneo. It occupies a total area of 5,770 square kilometres of which 5,270 square kilometres is land.

b) On April 18, 2006 Proprietary Industries Inc., a public company traded on the Toronto Stock Exchange ("Proprietary") and Loon Energy Inc. ("Loon") announced that Proprietary had acquired all of the issued and outstanding shares of Frontier Holdings Limited ("Frontier") from Loon and from Nemmoco Petroleum Limited a third party private Bermuda Company ("Nemmoco", and together with Loon, the "Vendors"). Prior to the acquisition of such shares, each of Loon and Nemmoco owned 50% of Frontier. Frontier, a private Bermuda company, is a party to a series of farm-in agreements, which, subject to the approval of various government agencies, involve the acquisition by Frontier (collectively, with the purchase and sale of the Frontier shares, the "Acquisition") of the following oil and gas interests in Asia:

   - a 37.5% interest in a development and production lease (the "Development and Production Lease") covering a gas field; and
   - a 47.5% to 50% interest in five exploration blocks.

   As consideration for the shares of Frontier, Proprietary has issued and deposited into escrow, an aggregate of 14,958,838 common shares of Proprietary (the "Proprietary Shares"). The Proprietary Shares will be released from escrow (the "Escrow Release") and distributed to the Vendors, 7,479,419 to each of Loon and Nemmoco, upon receipt of the necessary government approval for the Acquisition which is currently expected to occur within 120 days. In addition, Proprietary has agreed to issue to the Vendors an aggregate of an additional 500,000 Proprietary Shares (250,000 to each of Loon and Nemmoco) for each 100 billion cubic feet of reserves of gas proven during the 5 years following the Escrow Release, up to a maximum of an aggregate of an additional 7,681,918 Proprietary Shares, in each case, subject to regulatory approval. In certain circumstances, Proprietary may be required to pay cash to the Vendors in lieu of issuing such additional Proprietary Shares.

In connection with the Acquisition, subject to the Escrow Release, Proprietary has granted options to acquire an aggregate of 4.3 million Proprietary Shares to certain directors, officers and employees of Frontier who will have key roles in the project.

The Frontier agreements call for payments to be made in respect of the reimbursement of prior expenses and finder's fees together with the obligation by Frontier to fund, in varying amounts, 10 exploration wells and 7 development wells over the next 36 months.

Total expenditures by Frontier in respect of the foregoing are currently expected to be approximately US$60 million during such period.

In the event the government approvals are not obtained within 120 days, the Acquisition will be unwound, the Frontier shares will be returned to the Vendors and the Proprietary Shares will be returned to Proprietary and cancelled.

CORPORATE INFORMATION

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Officers and Consultants

Ed Beaman
Engineering Advisor

Gord Case
Financial Advisor

Deb Cooke
Senior Accountant

Tim Elliot
President & CEO

Jock Graham
Vice President

Norm Holton
Chairman

Brian Mainwaring
Corporate Secretary

Michele Wiltshire
Executive Assistant

Listing

TSX Venture Exchange
Symbol: LEY

Subsidiaries

Zama Energy Ltd.

Loon Energy Limited
(a Cyprus Company)

Auditor

KPMG LLP
Calgary, Alberta

Banker

National Bank of Canada
Calgary, Alberta

Legal

Baker MacKenzie LLP
Bogota, Colombia

Gowling Lafleur Henderson LLP
Calgary, Alberta

Registrar & Transfer Agent Services

Computershare Investor
Calgary, Alberta

produced by ion communications

Loon

www.loon-energy.com

LOON ENERGY INC.